75. BellSouth has also thwarted competition by shrinking the intraLATA toll market. It has aggressively expanded its local calling areas, and thus transformed what used to be intraLATA toll calls (subject to competition) into local calls (which are not subject to competition).[64] Moreover, BellSouth has recently introduced new calling plans in Georgia and Florida that offer a flat-rate for all calls within the LATA.[65] In many instances, this flat rate is below the usage-sensitive access charges that its competitors must pay for the same calls. Through this classic price squeeze, interexchange carriers are prevented from competing with BellSouth, even if they are more efficient.

76. In addition, the Florida and Kentucky commissions have recently ordered BellSouth to stop employing a number of anticompetitive marketing practices in the intraLATA toll market (and a similar complaint is pending in Georgia).[66]

77. While these examples illustrate the range of strategies that BellSouth has employed to deter the emergence of effective competition, it is important to remember that because it is difficult to detect such behavior, only a small subset of anticompetitive activities

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[64] See, *e.g.*, *Investigation into Defined Radius Calling Plans*, Docket No. P-100, Sub 126 (North Carolina Utils. Comm, May 17, 1994); "Expanded Toll-free Calling Area Approved," Atlanta J. Const., Mar. 16, 1994.

[65] BellSouth General Customer Service Tariff, A3.4.4.A.1; A3.4.4.B.1.a.(1)(a)(Florida); BellSouth Georgia General Subscriber Service Tariff, A3.42.

[66] Florida Public Service Commission Order No. P.S.C. 96-1659-POP-TP, Docket Nos. 960658-TP, 930330-TP; Kentucky Public Service Comm'n Case Nos. 95-285, 95-396 (Aug. 13, 1996); Complaint of MCI, AT&T, and Worldcom, Georgia Pub. Serv. Comm'n Docket No. 5319-U (Dec. 23, 1996).

are likely to be observed in the trade press and regulatory proceedings.[67]

IV. CONSEQUENCES OF BOC ENTRY INTO LONG DISTANCE SERVICES

78. As we noted at the outset, we do not recommend the approval of BOC applications such as BellSouth's to compete in interLATA services pursuant to Section 271 of the Act at this time. We recommend delaying BellSouth's entry until the emergence of effective local exchange competition is safely assured. As long as BellSouth possesses significant market power over essential local exchange facilities, its entry into interLATA services will harm the competitive process in both local and long distance services. We believe that the likely consequence of premature BellSouth entry will be higher long-run prices, reduced consumer choices, and poorer-quality services for both long distance and local exchange customers. On the one hand, examination of the potential *benefits* of BellSouth's entry reveals consumers would gain little, if anything. On the other hand, examination of the potential costs of BellSouth's entry reveals that consumers are likely to face significantly higher costs of service.

[67] Professor Marius Schwartz discusses the generic shortcomings of regulation to control anticompetitive abuses, noting the greater difficulty associated with regulating new types of services (*e.g.*, markets for UNEs). Regulators must be able to (1) detect abuses, (2) prove that abuses have occurred; (3) deter abuses; and, (4) correct abuses. Each of these tasks is complex and likely to be further complicated by BOC entry into interLATA services. See *Affidavit of Marius Schwartz, Competitive Implications of Bell Operating Company Entry into Long-Distance Telecommunications Services*, note 10, *supra*, pages 45-47.

A. Benefits of BOC Entry?

79. There are three types of benefits which proponents have argued will be realized when BOCs generally are permitted to enter long distance services:

i. Long distance markets will become more competitive.

ii. BOCs will be able to capture additional scale and scope economies through vertical integration.

iii. The promise of the opportunity to enter long distance services is the "carrot" which will induce the BOCs to cooperate with entrants.

80. Each of these alleged benefits is illusory. First, long distance markets are already effectively competitive; additional entry, therefore, will not make them meaningfully more competitive. Second, BOC vertical integration is unnecessary to capture such scale and scope economies as may exist when customers can purchase both local and long distance services from a single provider. Third, the "carrot" of long distance entry is effective only as long as the BOC has not been allowed to eat it. It will be necessary to induce the BOC to continue to cooperate with local exchange competitors as long as the BOC possesses significant market power over local services. The question is, again, not *if* a BOC should be allowed to compete in long distance, but *when* the BOC should be permitted.

1. Long distance markets will not become more competitive with BellSouth entry.

81. In Section III, we discussed the considerable evidence that demonstrates the vigorous nature of competition in long distance services. There is already significant excess capacity among just the three largest national facilities-based carriers. Moreover, the existence of a competitive wholesale market for bulk long distance transport means that entry and exit barriers for resellers are quite low. This makes the long distance market competitive (*i.e.*, free entry precludes the earning of more than normal returns by incumbents). Therefore the addition of one or even seven new competitors will not meaningfully increase the level of competition. Furthermore, the BOCs would bring no new skills or resources to the market which are not already available in abundance and competing aggressively.

82. It is conceivable that long distance prices may fall in the short term if the BOCs are permitted to enter long distance services while they continue to maintain access rates vastly in excess of cost or attempt to buy market share by pricing interLATA services below cost. Such a strategy could emerge through cross-subsidization from a BOC's local service business; by integrating into long distance the BOC may strengthen its present dominant position in local services and perhaps establish future dominance over long distance services. Under such a strategy, a BOC might be willing to incur a short-term loss in providing long distance service if such a loss enables it to maintain monopoly control over local services. This opportunity would not exist if the BOCs were not allowed to compete in

interLATA services until local service is effectively competitive because this incentive to pursue such a strategy disappears once the BOCs no longer have market power over local services.

83. Market conditions in long distance services indicate that current prices net of access prices cannot be significantly above long run incremental costs. Therefore a temporary price war which reduces prices below incremental costs in the short run would be anticompetitive and would be likely to harm consumers' interests in the long run (*e.g.*, because of the adverse effect on incentives to invest or the adverse effect on the competitive process).

2. Entry by BellSouth is not required to capture scale and scope economies.

84. It is also incorrect to argue that vertical integration is required to capture scale and scope economies. First, the sources of these alleged scale and scope economies are not clear. Much of the technical progress which has made it feasible for competition to succeed in long distance markets -- and which promises the opportunity that competition may emerge in local exchange services -- has *reduced* the impact of network-level scale and scope economies. Digitalization, standardization, and modularization have made it feasible to support complex information services across networks which span multiple management and ownership domains. The Internet is a testament to this fact. Before these technical advances, it was much more difficult to manage distributed networks and claims of

significant scale and scope economies were harder to dismiss. Today, there may still exist scale and scope economies within either the long distance or the local exchange networks, but it is not clear what network economies require integration of these two networks under control of a single end-to-end firm. Today, most analysts do not believe that end-to-end telephone services are a natural monopoly. Essential local facilities do, however, remain a *de facto* monopoly.

85. Second, if network scale and scope economies between local and long distance services do exist, then a BOC would have an unfair advantage because of its monopoly control over local network facilities. To guarantee effective competition in long distance services, regulators should continue to require equal access facilities and would need to make sure that the BOC did not exploit its unfair advantage to harm either local or long distance competition until effective local competition emerges.

86. Third, suppose that scale and scope economies exist, but that they are associated with *marketing* functions rather than with the network. There is ample evidence that many consumers will prefer one-stop shopping with the opportunity to purchase both long distance and local services from a single service provider. By bundling a package of services, a firm can economize on billing and marketing costs and can address customer-specific concerns more flexibly, thereby improving the quality of service. The promise of such opportunities for customer choice is anticipated to be one of the most important benefits delivered by increased competition in local services. However, it is

essential that the customer be able to choose among more than one end-to-end supplier, and this would not occur with premature interLATA entry. Furthermore, resellers are able to capture the benefits of any marketing-level scale and scope economies.[68]

3. The promise of the opportunity to enter long distance services ceases to provide incentive for BOC cooperation once entry is permitted.

87. It is clear from Bellsouth's conduct described above, that a BOC has little incentive to cooperate willingly with regulatory policies which are intended to reduce its control over local exchange services. Therefore one might be tempted to argue that the BOC must be relieved of the restriction from entering interLATA services in order to provide the BOC with an incentive to cooperate in the emergence of local competition. There are a number of problems with this argument.

88. First, as we noted earlier, the carrot of interLATA entry ceases to be effective once consumed. Threatening a BOC with the possibility that it could be forced to exit if it behaves in an anticompetitive manner might not be sufficiently effective because regulators or a court may be reluctant to force a BOC to abandon sunk entry investments and it would be very hard to monitor its anticompetitive behavior as the earlier (and subsequent)

[68] BellSouth affiant Richard Gilbert argues that economies of scale and scope "are likely to be significant, and may not be fully realizable through contracts." He does not, however, address the concerns we raise in this paragraph. See *Affidavit of Richard J. Gilbert on Behalf of BellSouth*, note 7, *supra*, page 16.

discussion of its strategic options makes clear.

89. Second, this argument often implicitly assumes that the Act reflected a "bargain" with the BOCs in which they agreed to give up control of local services in return for something they wanted, namely entry into interLATA services. The Act could not have been a bargain with the BOCs because they had nothing to bring to the bargaining table. BOCs do not have a property right over local markets to use as a bargaining chip. The Act reflected a shift in regulatory paradigm to a new, market-based mechanism for protecting consumer -- not BOC -- interests.

90. Finally, we do not believe it would be correct to deny the BOCs the opportunity to compete in interLATA services forever. However, delaying BOC entry until there is effective competition in local markets is neither inefficient nor unfair, but necessary for the realization of the Act's goal of full competition for all telecommunication services.

B. Costs of BOC Entry?

91. In general, premature BOC entry into interLATA services will incur five types of costs:

i. increasing the likelihood of anticompetitive vertical price squeeze strategies.

ii. increasing the likelihood of anticompetitive strategies designed to raise rivals' costs, more generally.

iii. increasing the likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets.

iv. decreasing the likelihood that the BOC will cooperate with local exchange entrants, as required by the Act.

v. increasing the costs of regulatory oversight to protect consumers and the competitive process, and forestalling the development of local competition.

In each case, the competitive process in both long distance and local exchange markets will be harmed if the BOC is permitted to enter interLATA services while it retains its local monopoly.

1. Increased likelihood of anticompetitive vertical price squeeze strategies

92. A virtual monopolist who also sells a complementary service (by itself or through its affiliate) can impose a *vertical price squeeze* on a competitor in the complementary product market. This happens because the monopolist controls the price of an input of its competitor in the market for the complementary service.[69] For example, a

[69] BellSouth affiant D. John Roberts focuses his attention on the potential for predatory pricing by BellSouth; we agree that classic predatory pricing in this setting is unlikely given the financial health of the interexchange carriers. Professor Roberts acknowledges, however, that a vertical price squeeze, while not fitting within his analysis of "predation," "is clearly damaging

BOC controls the price of access to the loop by an IXC. If the BOC, or its affiliate, is allowed to provide interexchange services as well, it can continue to price access to its competitors significantly above cost while pricing to itself at cost, and thereby squeeze the profit margin of the IXC. The vertical price squeeze can be pushed all the way up to the point where the IXC's profit margin becomes negative.

93. Implementation of a vertical price squeeze by a BOC will allow the BOC or its affiliate to charge prices for interexchange services that are significantly (and artificially) below the prices of its rivals even though the BOC may be a less efficient provider. This is a potent and quick way for a BOC (or its affiliate) to gain market share and customer loyalty for interexchange services.[70]

94. Presently, the access market is monopolized. In the absence of regulatory intervention, the control of the access market by the BOC results in significant monopoly profits. The existence of high profit margins allows for the possibility of the implementation of the vertical price squeeze. As the Telecommunications Act of 1996 is implemented by the

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to competition." See *Affidavit of D. John Roberts on Behalf of BellSouth*, note 8, *supra*, page 11.

[70] Professor Schmalensee argues that an ILEC's ability to expand long-distance output even where it is less efficient than its rivals is not problematic because the loss in economic efficiency "would be outweighed by efficiency gains from the expansion of industry output as long distance prices are driven closer to economic costs." *Affidavit of Richard L. Schmalensee*, note 6, *supra*, at page 24. The argument rests on a false premise: as demonstrated *supra*, at Section III.A and *infra*, at Section VI.A, the long distance market is already competitive and prices already approximate economic costs. Therefore, there is no countervailing benefit to an ILEC's anticompetitive price squeeze.

state commissions and as new facilities-based competitors enter the local exchange market, the market for access services, unbundled network elements, and local exchange services should become more competitive. Such competition will render a vertical price squeeze less effective. Thus, from the point of view of the BOC, the present is the opportune moment to impose a vertical price squeeze and gain significant market share in the IXC market.

2. Increased likelihood of anticompetitive strategies designed to raise rivals' costs, more generally

95. A BOC will also be able to exercise market power by bundling services and making it more difficult for customers who subscribe to more than one service to switch carriers. Such bundling schemes will be much more effective for a firm with near monopoly market power in one portion of the bundle, here in the provision of local service. If a firm has significant market power, its competitors will have, even in the absence of bundling by the dominant firm, a difficult time attracting customers. A BOC's position as the entrenched monopoly provider will make it difficult for other firms to convince customers to switch carriers. If the BOC sells to customers bundles of local and toll services, the willingness of customers to switch will be that much less and the BOC's operation, as a whole, will be able effectively to lock in a significant portion of its customer base.

96. We stressed earlier the importance of both price and nonprice anticompetitive strategies available to the BOC. Forward integration by the BOC into long distance services would increase the span of potential markets, services and products which could provide a

basis for anticompetitive strategies. This integration would expand the range of opportunities to engage in those strategies, would make it more difficult to detect or deter such behavior, and would increase incentives and opportunities to fund such behavior. For example, entry into unregulated long distance services would increase incentives to cross-subsidize and to engage in other anticompetitive strategies to evade continuing local service regulations.[71]

3. Increased likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets

97. The BOC can easily cross-subsidize its long distance operation (or its long distance affiliate) by not requiring its long distance affiliate to pay the full cost of the inputs it uses. For example, the long distance operation of the BOC will use the brand name of the BOC, one of its most important assets, without payment -- clearly cross-subsidization. Further, it is not clear how the costs will be divided in the joint marketing of the long distance and the local operations, raising the possibility of additional opportunities for cross-subsidization.

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[71] Indeed, BellSouth's economic witness Glenn A. Woroch acknowledges that "[t]here are several potential anticompetitive practices which an integrated ILEC such as BellSouth might theoretically take." *Affidavit of Glenn A. Woroch on Behalf of BellSouth*, in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision on In-region, InterLATA Services in South Carolina, Before the Federal Communications Commission, page 21 (October 1997); see also id., at page 21 ("Strategic behavior by an ILEC would become a concern . . . when its control of bottleneck network services is used to discourage entry into downstream markets, especially retail local exchange and long distance.")

4. Decreased likelihood that the BOC will cooperate with local exchange entrants, as required by the Act

98. Entry by a BOC into interLATA services results in a fundamental change in the BOC's incentives to discriminate among long distance carriers. When the BOC is restricted to offering local services, the BOC has no incentive to favor one long distance carrier over another. Because local access and long distance are complements (*i.e.*, a local loop is required to complete a long distance call), the BOC has an incentive to encourage as much long distance competition as possible. Competition in long distance drives down toll charges, stimulating demand for long distance services. In turn, BOC revenues increase both because of increases in access revenue -- which significantly exceeds the incremental cost associated with the traffic -- and because consumers who pay less for long distance service are likely to be willing to spend more on local services.

99. Once a BOC is also a long distance carrier, it has a strong incentive to discriminate in favor of its own long distance business. Before entry, local and long distance are complements; after entry, the BOC and other long distance carriers are competitors, and thus the BOC will lack the necessary incentive to provide services to the interexchange carriers, which the latter require in order to compete with the BOC both as a competing local exchange carrier and as a long distance carrier.

5. Increased costs of regulatory oversight to protect consumers and the competitive process and delaying the development of local competition

100. The most important social cost of premature BOC entry into interLATA services is likely to be the forestalling of the emergence of effective local competition. Implementing the pro-competitive policies of the Act is quite difficult and is likely to require substantial regulatory oversight as long as the BOCs retain significant monopoly power over essential facilities. It is important to understand that the difficulties of introducing competition into local exchange markets are likely to be significantly greater than it was to introduce competition in long distance, which explains the need for more stringent regulatory requirements such as the unbundling and total service resale provisions of Section 251.

101. Introducing local service competition is more difficult for at least five reasons. First, the capital investment per customer is much larger for local services than for long distance. In 1995, the investment-per-subscriber line was $1,828 for local services compared to $255 for that for AT&T -- a more than sevenfold difference.[72] This means that the BOC is likely to retain its role as the monopoly provider of facilities in many local markets for a number of years.

102. Second, entry into local services requires competitors to cooperate much more extensively than was necessary in long distance markets. In local services, entrants will need to purchase essential UNEs, wholesale, and interconnection services from a competitor.

[72] See *Statistics of Communications Common Carriers 1995/1996*, Federal Communications Commission, November 27, 1996. Local exchange plant in service was $278.946 billion (Table 2.7) and there were 152.601 million subscriber lines (Table 2.3); AT&T's total plant in service was $25.894 billion (AT&T financial data maintained in conformance with regulatory requirements) and there were 101.357 million subscriber lines (Table 8.12).

During the early days of long distance competition, competitors needed to both interconnect with AT&T and lease wholesale transport facilities, but this dependence was never as great and did not last as long as the CLECs' dependence on the BOC. In the long distance context, the option to build long distance transport bypass facilities offered more effective discipline than the analogous option of local bypass in local exchange markets.

103. Third, the technology of local exchange competition means that providers have less flexibility in where they locate facilities than does a long distance carrier. To provide local loop service, a carrier needs loops that go to each house. To provide long distance service, a carrier can locate its point of presence much more flexibly; its only constraint is that it sits within the LATA. This is also true for the location of switches and long-haul transport facilities. This added flexibility in the interLATA arena lowers the costs of constructing facilities and increases opportunities for competition among facilities over a wider geographical range.

104. Fourth, with BellSouth precluded from interLATA services, and consequently interested in promoting increased competition, regulators and the BOC's interests regarding the promotion of long distance competition are aligned. This alignment of interests eased the burden on regulators immediately following divestiture when effective competition was emerging because BellSouth is likely to have much better information about underlying costs and demand than is available to the typical regulatory agency. No alignment of interests exist with respect to local markets.

105. Fifth, the local services provided by the BOC are an essential input to a wider class of products and services than is long distance and so there are a greater array of monopoly leveraging opportunities, giving the BOC a greater incentive to preserve its local monopoly.

106. Elimination of one form of simple regulation (*i.e.*, the interLATA entry restriction) would create increased incentives and opportunities for anticompetitive strategies which would be harder both to detect and to deter. Therefore premature entry by a BOC into interLATA services would increase the overall regulatory burden on state commissions and the FCC, which already face a significant regulatory challenge promoting local service competition.

V. RESPONSE TO CLAIMS OF JERRY A. HAUSMAN

107. Professor Hausman makes two main points in his declaration.[73] First, BOC entry into long distance will reduce long distance prices significantly, yielding economic benefits to residential customers of $6-$7 billion dollars per year. Second, if BOCs are permitted to enter long distance markets, then incentives for local entry are enhanced as both BOCs and interexchange carriers will want to offer "one-stop shopping" to residential customers. We refute these claims below.

A. BOC Entry and Local Competition

108. As our analysis presented in Section III.A makes clear, long distance markets

[73]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*.

are already effectively competitive. Hence, little long-term gain in economic efficiency in the form of benefits from lower long distance prices is possible. Professor Hausman's justification for the claim of lower long distance prices is founded largely in his analogy to pricing by Southern New England Telephone (SNET) in Connecticut and GTE in California.[74] This reliance is misplaced.

109. Both Professor Hausman and Professor Gilbert present a misleading picture of the competitive impact of SNET on Connecticut telecommunications markets. First, the major IXCs offer nationwide rates that are comparable to SNET's long distance prices. SNET's interexchange rates, which are billed in one second increments, range from 23 cents during the day to 13 cents at night (or a flat 15 cent flat rate), and only provide small discounts for high volumes.[75] In comparison, AT&T One Rate and Sprint Sense Day Plan each offer flat rates of 15 cents a minute to all customers, at all times, regardless of calling volumes. Further, AT&T offers a 10 cent flat rate for a $4.95 monthly fee. Sprint also offers a flat rate of 10 cents per minute for domestic calls between 7 P.M. and 7 A.M., and 25 cents for other domestic calls. It is also currently offering $50.00 a month in free calls

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[74]According to Professor Hausman, "overall SNET residential prices were about 18.4% less than AT&T's on average" (see *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 11). Related arguments about the experience with SNET in Connecticut are presented by Professor Gilbert. See *Affidavit of Richard J. Gilbert on Behalf of BellSouth*, note 7, *supra*, pages 18-20.

[75] Although Professor Hausman maintains that "SNET offers a discount of 10%-15% off the $0.15 per minute price depending on monthly calling volume," according to SNET sales representatives, subscribers to SNET's 15 cent flat rate plan are not eligible for any volume discounts.

on Monday evenings. MCI also offers a competitive flat rate: 12 cents a minute at all times to customers who make over $15.00 a month in calls. Further, it offers all residential customers a 5 cent per minute rate on Sundays. Plainly, even taking into account SNET's one-second billing increments, there is no obvious consumer benefit flowing from SNET's entry into the interexchange market.

110. Moreover, SNET's ability to capture market share is not attributable to any greater efficiencies. Rather, SNET's success is due to its bundling of long distance offerings with its monopoly provision of local services, and to its aggressive promotion of PIC freezes for its own long distance customers. Furthermore, through a recently announced corporate reorganization, SNET has attempted to rid itself from the Act's requirement that it resell local services at a wholesale discount.[76] Thus, contrary to Professor Gilbert and Professor Hausman's contentions, the SNET experience does not prove the benefits of permitting a monopoly ILEC into an in-region, interLATA market. Rather, SNET's behavior illustrates precisely what an ILEC will do to avoid opening its market to competition.[77]

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[76] See AT&T v. Commissioners of the Connecticut Dep't of Pub. Util. Control, Civ. Action No. 397CV01601, Complaint for Injunctive Relief and Declaratory Judgment, ¶ 9 (filed Aug. 8, 1997).

[77] Dr. William E. Taylor's testimony that interLATA rates in the New York/New Jersey corridor demonstrate that BOC entry into in-region, interLATA markets will foster competition is similarly flawed. See *Direct Testimony of Dr. William E. Taylor of Behalf of BellSouth Long Distance, Inc.*, Before the South Carolina Public Service Commission, Docket No. 97-101-C, page 18. Although customers can presubscribe to Bell Atlantic/NYNEX for Eastern corridor calls, they must then dial a 10-XXX carrier access code for interLATA calls outside the corridor. Consequently, very few customers have presubscribed to Bell Atlantic/NYNEX, and most Eastern corridor Bell Atlantic/NYNEX intraLATA calls require an access code. These

111. Moreover, Professor Hausman provides no evidence that any price discounts that may exist are likely to be long-term, which is the appropriate basis for computing the welfare benefits that he claims. Both SNET and GTE are monopoly providers of local service. As such, they have a clear incentive to protect and extend their market power. They currently receive substantial subsidies in the form of interexchange access charges and revenues from other local services with prices that greatly exceed costs (*e.g.*, prices for business lines, vertical switch features, etc. are generally accepted to be significantly above economic costs[78]). Furthermore, SNET and GTE have an incentive to use these subsidies to cross-subsidize their efforts to acquire future "one-stop shopping" customers, which will increase economic entry barriers faced by CLECs seeking to compete in their markets.

B. One-Stop Shopping

112. While we agree with Professor Hausman that one-stop shopping is a desirable feature for residential customers, consumer choice in one-stop shopping is not possible until local markets become more competitive.[79] Indeed Professor Hausman appears to define the

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obvious competitive handicaps, and not greater efficiencies, have forced the BOC to lower its interLATA rates.

[78]BOC respondents argue that pricing access, business, and vertical feature services above cost is necessary in order to recover the costs of providing service to residential customers at rates that are below costs. While no one disputes that access and a large class of services are priced significantly above costs, the BOCs have not been able to demonstrate that service to the average residential user requires a subsidy.

[79] A similar response can be offered for the claims by BellSouth affiant Richard Gilbert, see *Affidavit of Richard J. Gilbert on Behalf of BellSouth*, note 7, *supra*, Section III.

public interest intent of the Telecommunications Act of 1996 narrowly by focusing solely on the effect of BellSouth's entry on long distance services. As we argued earlier, BellSouth's entry into interLATA services before the emergence of effective local service competition is likely to harm the competitive process in both local and long distance markets. Indeed, the potential welfare losses from delaying the emergence of local competition are likely to be very large. This is true because the reduction in prices is likely to be very significant (because local services are an effective monopoly today), because local access service is an essential input for long distance, and because the local market is an order of magnitude larger. A modest $0.01 per minute reduction in the effective price of local calls could save consumers on the order of $15 billion per year, more than twice the amount estimated by Professor Hausman from reducing long distance prices by over 18 percent.[80]

113. Professor Hausman argues that the welfare effect of increased competition in local services would be small to the "extent that regulation has been effective" (presumably) in constraining local prices so that they do not exceed efficient long run economic costs.[81]

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[80]According to FCC data, there were approximately 502 trillion local calls in 1996. Assuming an average call length of three minutes, a $0.01 reduction in the average price for a local call would provide consumer benefits of $15 billion, even if we assume that the price elasticity of demand for local calls is zero (see Federal Communications Commission, *Statistics of Common Carriers 1996*, Table 10, for local call data). Assuming an average flat rate for local service per month of $20 and 200 minutes for local calling a month implies an average local call cost of $0.10 per minute, implying the hypothesized price reduction is 10 percent. We provide these back-of-the-envelope estimates solely to suggest the magnitude of the gains achievable from introducing effective local competition.

[81]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 17.

Were one to accept Professor Hausman's presumption, then the Telecommunications Act of 1996 would not have been necessary.[82] This is implausible. A more reasonable expectation is that competition will force ILECs to both reduce prices closer to costs and to aggressively seek to minimize costs. These cost and price reductions will deliver large welfare benefits to consumers of both local services, long distance services, and indeed, all telecommunications services that require local access as an essential input.

114. Professor Hausman's arguments fail to convince because they neglect to adequately consider the full impact on the overall price that consumers will pay for "one-stop shopping." Long distance services are only part of the bundle. If reduced prices for long distance services in the short-run are paid for by delaying progress towards sustainable lower prices for local services then consumers will be harmed and the public interest will not be served. Competition that allows consumers a choice among suppliers for their one-stop shopping services offers the surest mechanism for guaranteeing that prices for both local *and*

[82]Professor Hausman also argues that the "own price elasticity of local exchange service is near zero" (see *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 17). This is misleading because it confuses demand for local access (which supports both long distance and local calling) and demand for local usage. Because most subscribers purchase flat rate local service, it is difficult to estimate a separate price demand elasticity for local usage; however, it is highly unlikely that it would be zero. Because demand for basic access is commonly believed to be highly inelastic (near zero), most economists favor recovering non-traffic sensitive costs from users as part of the flat rate access charge and charging usage at closer to its incremental cost. Professor Hausman is referring to this sort of rate rebalancing in his footnote 26. The relevant question, however, is whether consumers are paying more than they would under competition for the bundle of local access and calling services that they purchase.

long distance services are as low as possible.

115. Professor Hausman would have us believe that the benefits of lower prices for long distance services in the short run and the rapid delivery of a single "one-stop" shopping alternative to consumers outweigh any costs remaining from barriers to local entry. While striving for regulatory perfection is not likely to be efficient, one cannot simply ignore -- as Professor Hausman does -- the welfare gains to be obtained from greater local competition. As we noted above, the welfare gains from greater local service competition in BellSouth's territory are plausibly much larger than any speculative welfare gains from BellSouth's entry into in-region, interLATA services. Moreover, while we agree with Professor Hausman that "if the BOCs have satisfied the provisions of Sections 271 and 272 of the Telecommunications Act of 1996, then significant barriers to local entry have been removed,"[83] we see no evidence that this standard has been met, even in its grossest form, much less the 95 percent level hinted at by Professor Hausman.[84]

116. Professor Hausman points out correctly that the United States is unique in requiring separation between the ILEC and long distance services.[85] He, however, fails to point out that the United States is also unique with respect to its requirements for network

[83]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 18.

[84]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 6-7.

[85]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 18-20.

unbundling and total service resale. For these pro-competitive policies to be effective, the ILEC must cooperate -- and the ILEC has little incentive to do so, as already noted. The Section 271 requirements cannot be examined in isolation, but need to be considered within the larger context of the Act and its goal of promoting effective local competition.

117. Professor Hausman argues that allowing the ILECs to enter interLATA services would increase the incentives of IXCs to compete in local services.[86] The desirability of integrating into local services in order to offer "one-stop shopping' is well understood. The Telecommunications Act of 1996 recognized that entrants face formidable economic entry barriers in competing with an ILEC in its home market, and hence, the Act required network unbundling at cost-based rates so as to place the ILEC and CLECs on an equivalent footing with respect to essential inputs. The CLECs do not need improved incentives for entering local services (which they already have); rather, they need the opportunity to avail themselves of the pro-competitive policies that are guaranteed under the Act. Permitting the BOCs to enter interLATA services at this time will harm rather than help prospects of successfully implementing the network unbundling provisions of the Act.

VI. RESPONSE TO CLAIMS OF RICHARD L. SCHMALENSEE

[86]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 4.

118. Professor Schmalensee[87] offers two principal conclusions in his declaration. First, residential long distance markets are inadequately competitive. Second, BellSouth's low incremental costs and good marketing position make it a credible competitor in the interexchange market. We address these points below.

A. Imperfect Competition in Long Distance

119. We addressed earlier the wealth of evidence that contradicts Professor Schmalensee's assertion that long distance markets are inadequately competitive. He argues that prices have failed to fully reflect the full decline in access charges that has occurred since 1993, and that this is sufficient to demonstrate that long distance markets are not adequately competitive. First, access charges are an important input cost, but they are not the only input cost. Increases in other cost categories such as marketing-related costs or uncollectibles may offset any savings associated with reductions in access charges. Second, changes in tariff prices provide only a noisy and inappropriate estimate of changes in average revenue per minutes (ARPM), which offers a superior summary statistic for assessing price trends. There may be changes in demand patterns that make it difficult to associate reductions in access charges directly to changes in tariffed prices. If one insists on considering patterns in tariff prices, then it is more informative to consider the least-cost options for delivering service to each category of consumer (see Figure 5). Third, as we noted earlier, ARPM net of access declined for AT&T, which refutes Professor

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[87]See *Affidavit of Professor Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*.

Schmalensee's principal assertion.

120. Professor Schmalensee is also incorrect in asserting that the patterns of market share changes in long distance imply the existence of tacit price collusion.[88] He appears to be arguing that there are stable market shares in long distance markets and that is conducive to collusion. As a matter of theory, of course, evidence of stable market share is thought of as a potential *consequence* of collusion, not as a *precondition* for collusion. In any event, AT&T has continued to lose market share since 1989, and the loss in market share has not been captured entirely by MCI and Sprint. There is an obvious reason that long distance is not conducive to a collusive stability of market shares. Currently, long distance carriers cannot avoid competing for each others' customers. That is, they have no natural way to divide the market. By contrast, a BOC entrant such as BellSouth would have a natural means of dividing the market based on geographic point of origin.

121. Professor Schmalensee also overestimates margins in long distance, claiming that margins are on the order of $0.08 per minute, reflecting a price-cost margin of 80 percent using his numbers.[89] This is implausible. First, he fails to explain why margins of this magnitude -- if actually realized -- would fail to attract significant entry from the many potential entrants into long distance services. Because all of the essential inputs for entering

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[88]See *Affidavit of Professor Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, page 6.

[89] See *Affidavit of Professor Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, page 11.